Australian Government
The Treasury

DECEMBER 2013 MEETING OF THE JOINT ECONOMIC FORECASTING GROUP

ECONOMIC OUTLOOK FOR 2013-14, 2014-15 AND 2015-16

FEBRUARY 2014

This report incorporates domestic and international data released up to 21 February 2014.

EXECUTIVE SUMMARY

In MYEFO, the Australian economy was forecast to continue growing at a below-trend rate in 2013-14 and 2014-15, as the economy transitions slowly to non-resources drivers of growth.

The limited economic data released since MYEFO suggest that the transition remains patchy. While business conditions and retail sales have improved, conditions in the labour market remain weak.

However, with MYEFO published after the release of the September quarter National Accounts, the outlook for 2013-14 and 2014-15 will not be reassessed in detail until after the December quarter National Accounts released on 5 March.

This report is instead focused on the outlook for 2015-16, which, for the first time, is now a detailed forecast year rather than a projection year based on medium-term trends.

While resources investment is expected to fall sharply in 2015-16, activity in the non-resources sectors is forecast to grow at its strongest pace since the global financial crisis and new LNG exports are forecast to come online, helping to drive overall growth. Real GDP is forecast to grow at 3 per cent in 2015-16.

With growth returning to trend, employment growth is expected to improve but only sufficiently to stabilise the unemployment rate at 6¼ per cent through 2015-16.

Nominal GDP is forecast to grow at 4¼ per cent in 2015-16. Wage growth is expected to remain modest, helping limit growth in domestic prices. The trend decline in commodity prices is also expected to continue.

The significant risks to the outlook outlined in MYEFO remain, including the possibility that the transition to broader-based growth will continue to disappoint, particularly if current labour market weakness persists.

The outlook for 2015-16 is particularly uncertain, with the potential for a sharp decline in resources investment, and further falls in the terms of trade, to constrain the forecast recovery elsewhere.

Still, there are tentative signs that interest-rate sensitive sectors are responding to low interest rates. Should these signs gather pace more rapidly, leading to better conditions in the labour market and improved consumer confidence, this could result in a quicker rebound in activity than currently forecast.

With these contrasting risks, there is a significant divergence of views amongst committee members and private sector forecasters on the timing and pace of recovery in the non-resources sectors.

Internationally, the outlook for global growth appears to be improving, in what has been a very slow recovery, with sentiment improving in recent months. While forecasts have not been reassessed since MYEFO, growth is still expected to remain subdued. Activity in Japan and the United States has strengthened and the euro area is in a tentative and weak recovery, but growth in emerging economies as a whole has moderated. Downside risks, both new and old, remain, with developments in US monetary policy continuing to be a key factor.

Table 1: Key domestic and international forecasts[a]

	2012-13	2013-14		2014-15		2015-16	
	Outcome	MYEFO	Dec JEFG	MYEFO	Dec JEFG	MYEFO	Dec JEFG
Real GDP	2.7	2 1/2	2 1/2	2 1/2	2 1/2	3	3
Nominal GDP	2.5	3 1/2	3 1/2	3 1/2	3 1/2	4 3/4	4 1/4
Unemployment rate	5.6	6	6	6 1/4	6 1/4	6 1/4	6 1/4
Underlying inflation	2.5	2 3/4	2 3/4	2 1/4	2 1/4	2 1/2	2 1/2
WPI	2.9	2 3/4	2 3/4	2 3/4	2 3/4	4 3/4	3
Terms of trade	-9.8	-5	-5	-5	-5	-2 3/4	-3
World GDP (b)	3.2	2 3/4	2 3/4	3 1/2	3 1/2	3 3/4	3 3/4
Major trading partners GDP (b)	4.1	4 1/4	4 1/4	4 1/2	4 1/2	4 1/2	4 1/2
China (b)	7.8	7 3/4	7 3/4	7 1/2	7 1/2	7 1/4	7 1/4
United States (b)	2.8	1 3/4	1 3/4	2 1/2	2 1/2	2 3/4	2 3/4

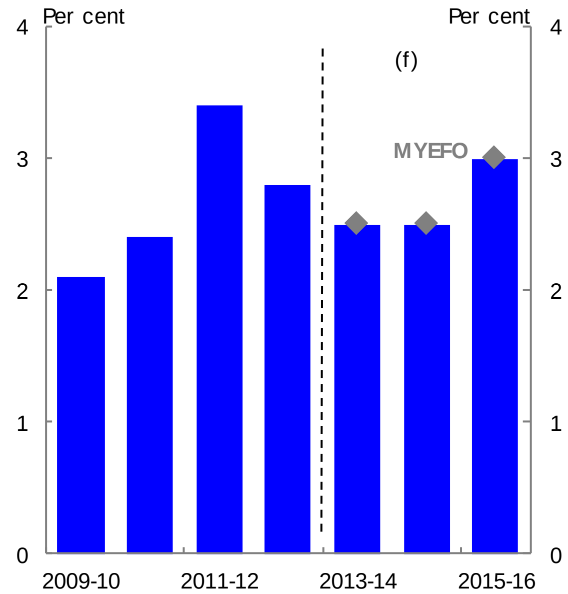
Note: Text in blue indicates a forecast upgrade, while red text indicates a forecast downgrade. Forecasts for the domestic economy are based on the assumption of a trade weighted index of around 70 and $US exchange rate of around 91 US cents.
(a) Real GDP, nominal GDP, the terms of trade, world GDP, major trading partner GDP, China and United States are year-average growth. Underlying inflation and the WPI are through-the-year growth to the June quarter. The unemployment rate is the rate for the June quarter.
(b) International GDP figures are calendar year average growth for 2013, 2014 and 2015.
Source: ABS cat. no. 5206.0, 5302.0, 6202.0, 6345.0, 6401.0 and Treasury.

Outlook for the Domestic Economy

Economic outlook for 2013-14 and 2014-15 has not been reassessed since MYEFO except to include actual outcomes

In MYEFO, the economy was forecast to grow below trend at 2½ per cent in both 2013-14 and 2014-15, with the unemployment rate drifting higher to 6¼ per cent by June 2015 (Chart 1). Since MYEFO, the ABS December quarter Consumer Price Index, January Labour Force and latest ABARES *Agricultural Commodities* and BREE *Resources and Energy Quarterly* have been incorporated into the forecasts.

Chart 1: Real GDP forecasts



Note: At MYEFO, 2015-16 was a projection year based on medium term trends.
Source: ABS cat. no. 5206.0 and Treasury.

Economic developments since MYEFO have been mixed

Economic data releases since MYEFO have provided a mixed picture about how the transition to non-resources drivers of growth has been unfolding.

Survey measures of business conditions and confidence have improved and buoyant conditions in the established housing market have continued into the New Year. Retail sales in the lead up to Christmas also appear to have been solid, with feedback from business liaison mixed as to whether this strength continued into 2014.

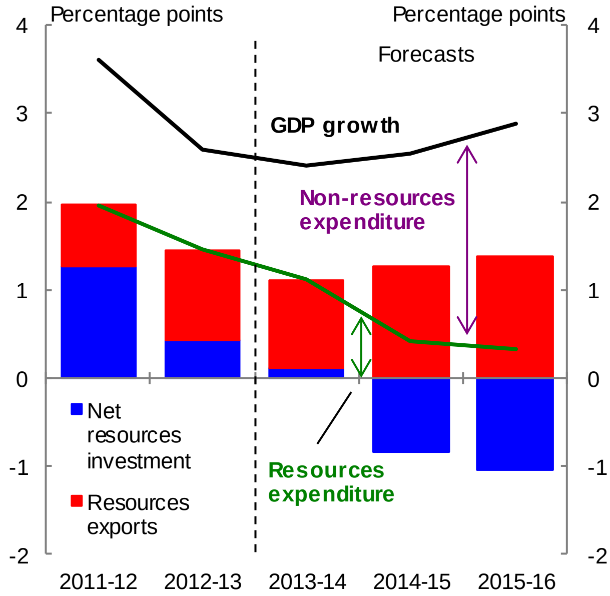
Offsetting this, labour market outcomes have remained weak and the unemployment rate, at 6.0 per cent in January, has risen to its highest level in over a decade. Wage growth in the December quarter also slowed to its lowest rate since the late 1990s. The weakness in the labour market is clearly weighing on consumer confidence, which is back below historical averages. This raises doubts around whether household expenditure will continue to gather the necessary pace to help rebalance growth in the economy. Commodity prices have also continued to decline, by a little more than expected at MYEFO.

These developments, along with the release of critical data, including the ABS December quarter Capital Expenditure Survey and National Accounts, over coming weeks will be taken into account during the upcoming March forecasting round.

Growth is forecast to improve in 2015-16…

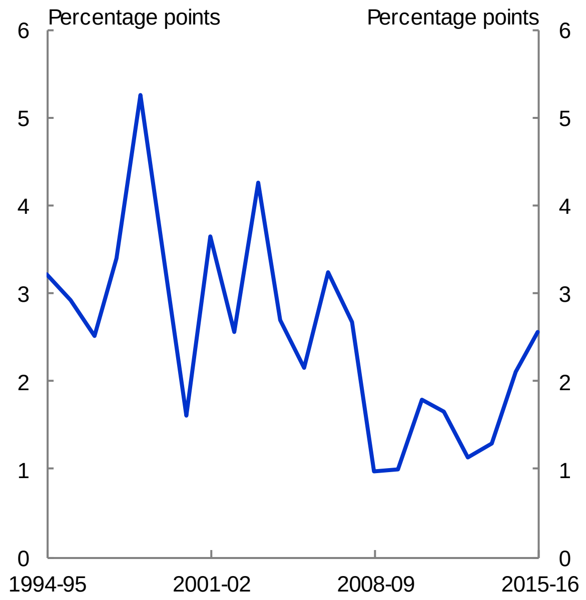
For the first time, 2015-16 is now a detailed forecast year. Real GDP growth is forecast to pick up to 3 per cent in 2015-16 (Chart 1). While resources investment is expected to experience its sharpest decline in 2015-16 (Chart 2 and 4), expanding activity in the non-resources sectors is expected to help drive growth higher (Chart 2 and 3).

Chart 2: Contributions to real GDP growth



Note: Assumes resources investment has an import share of 50 per cent.
Source: ABS cat. no. 5204.0, 5206.0, 5302.0 BREE and Treasury.

Chart 3: Non-resources sectors (contribution to total real GDP growth)



Note: The non-resources sectors contribution to growth is calculated by subtracting the resources sector's contribution from total GDP growth.
Source: ABS cat. no. 5204.0, 5206.0, 5302.0, BREE and Treasury.

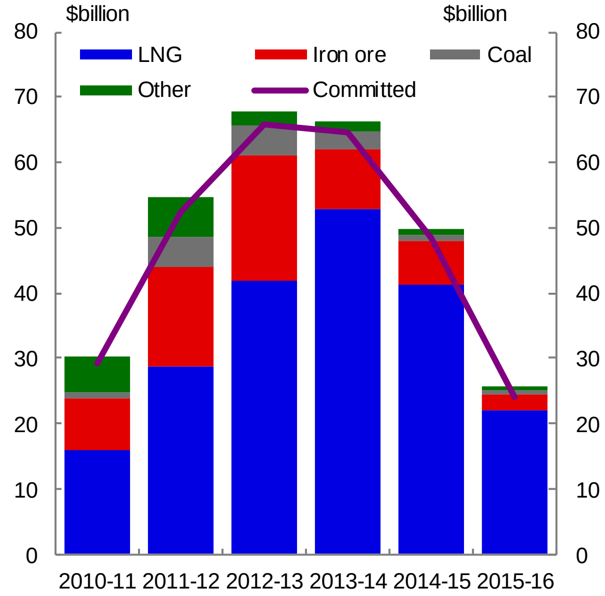
The forecasts for real GDP growth in calendar year 2015 are broadly consistent with private sector forecasters and the RBA's February Statement on Monetary Policy (see Appendix B). However, forecast real GDP growth for 2015-16 is below the RBA's latest forecasts which are based on a lower exchange rate assumption[1]. There is a wide forecast range in 2015 reflecting the considerable uncertainty around the timing and pace of recovery in the non-resources sectors. For estimates of the uncertainty around the forecasts please refer to Appendix A.

...despite resources investment falling sharply

A number of LNG projects currently underpinning investment activity are scheduled to complete construction in 2015-16. With a limited pipeline of new resources projects to replace them, resources investment is expected to fall by over a third in 2015-16 (Chart 4). Net of imports, resources investment is expected to detract around 1 percentage point from overall GDP growth in 2015-16.

1 The RBA's February Statement on Monetary Policy was based on a trade weighted index (TWI) of 69 and $US exchange rate of 89 US cents compared to the December JEFG of TWI at 70 and 91 US cents.

Chart 4: Resources investment – major projects

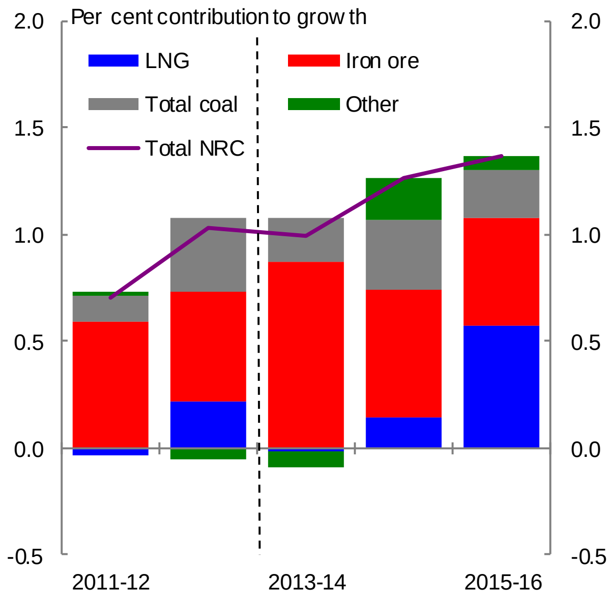


Source: Treasury.

As new LNG exports come online...

As investment in LNG projects winds down, LNG exports are expected to grow rapidly. LNG exports are expected to more than double in 2015-16, adding over ½ of a percentage point to real GDP growth (Chart 5). Combined with continuing strong growth in iron ore and higher coal exports, increasing resources exports are expected to contribute a 1¼ percentage points to real GDP growth in 2015-16.

Chart 5: Resources exports



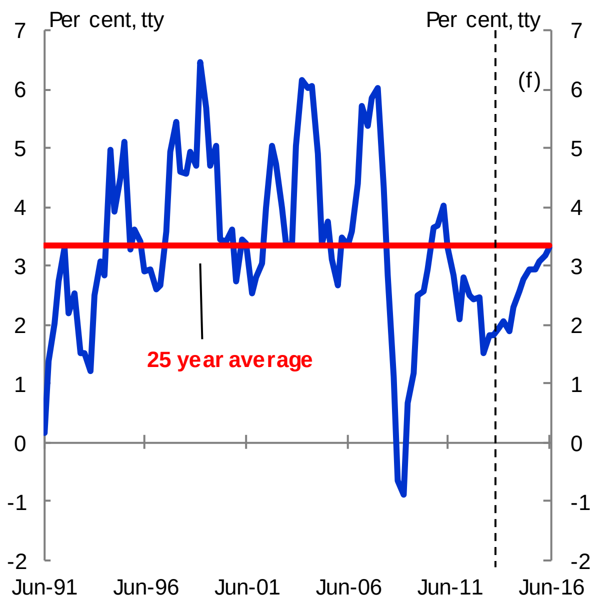
Source: ABS data and Treasury.

…and household consumption picks up

While the recent improvement in retail sales has been encouraging, sale volumes in the December quarter were only consistent with around trend growth. Retail sales and broader household consumption will need to gather further momentum to provide the necessary boost to support the transition to broad-based growth.

In 2015-16, a stabilising labour market and the accumulation of sustained gains in household wealth are expected to support increased consumer spending. Household consumption growth is expected to pick up to 3¼ in 2015-16 (Chart 6).

Chart 6: Household consumption growth



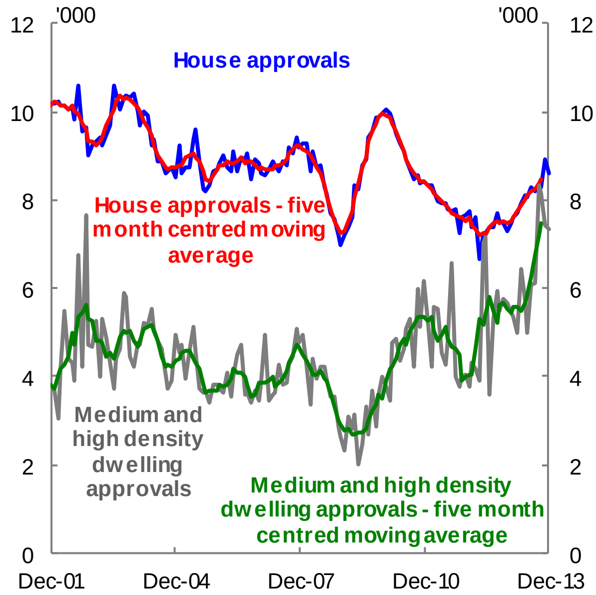
Source: ABS cat. no. 5206.0 and Treasury.

There are significant risks around the pace of recovery in consumption. Should the current weakness in the labour market persist and consumers continue to exercise caution, consumption growth may remain soft. However, should labour market conditions prove to be stronger than expected and consumer confidence returns, household expenditure could recover more strongly than forecast.

Dwelling investment to remain solid…

The current upswing in dwelling approvals is expected to support activity in the housing markets well into 2015-16 (Chart 7). Dwelling investment is forecast to continue growing solidly at 4 per cent in 2015-16.

Chart 7: Leading housing market indicators



Source: ABS cat. no. 8731.0 and Treasury.

…and investment in the non-resources sectors continues to recover

Business investment in the non-resources sectors is also expected to gain further momentum in 2015-16, as businesses respond to improving household demand and global growth. However, it is not expected to be enough to offset falling resources investment, with total business investment forecast to fall by 4 per cent in 2015-16.

Public final demand is expected to remain subdued

The fiscal consolidation underway at all levels of government is expected to continue in 2015-16. Current forecasts incorporate updated State budget estimates and announced Commonwealth Government policies in MYEFO. Public final demand is forecast to grow by 1¼ per cent in 2015-16.

The labour market is expected to stabilise…

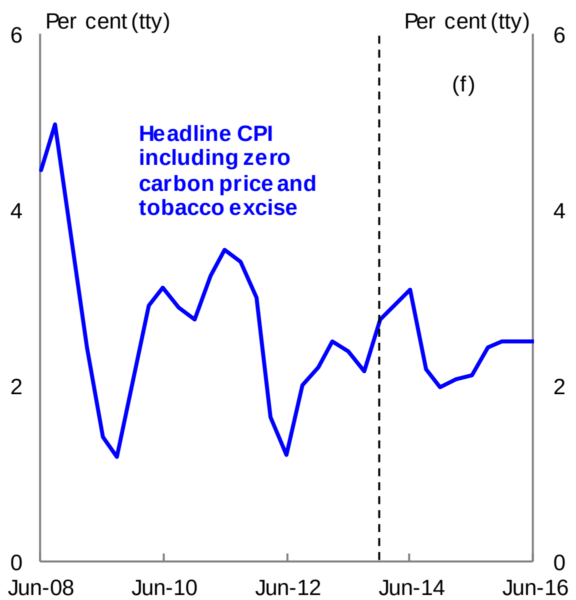
Improving activity in the non-resources sectors is expected to support employment growth towards the end of the forecast period. Employment growth is expected to pick up to 1½ per cent through the year to the June quarter 2016. Employment growth will also be supported by moderate wage growth of 3 per cent through the year to the June quarter 2016.

...with inflationary pressures remaining contained

Headline and underlying inflation in the December quarter 2013 were slightly stronger than expected. The prices of tradeable goods rose through 2013 for the first time since 2011, which may have been a result of a faster-than-usual pass through of the exchange rate depreciation. The increase in the price of non-tradeable items appears to reflect a slower than usual response to the soft labour market conditions. During the December quarter there was also seasonal strength in travel prices, a rise in fruit and vegetable prices following adverse weather in some areas and a strong rise in tobacco prices as a result of the increase in the tobacco excise.

While this highlights the exposure of inflation to future movements in the exchange rate, domestic price pressures are expected to remain modest in 2015-16, consistent with the soft outlook for wages. Headline and underlying inflation are expected to be 2½ per cent through the year to the June quarter of 2016 (Chart 8).

Chart 8: Headline inflation



Source: ABS cat. no. 6401.0 and Treasury.

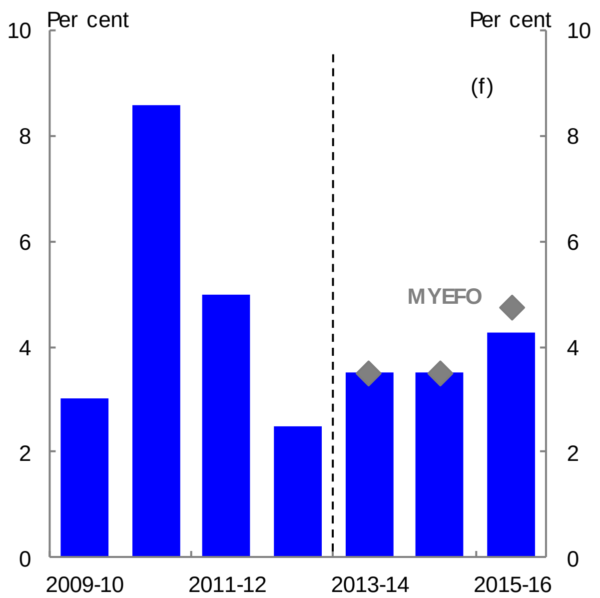
The terms of trade are expected to continue falling in 2015-16...

Commodity price falls since MYEFO have been a little sharper than forecast, particularly for metallurgical coal. The implication of this for the near-term forecasts will be reassessed in the March forecasting round. The medium term outlook for commodity demand and prices remains unchanged, with strong growth in iron ore supply, particularly from Australia, and increasing global supply of metallurgical and thermal coal, expected to weigh on prices. The terms of trade are expected to fall 3 per cent in 2015-16.

...and together with slower wage growth and further falls in the terms of trade are constraining nominal GDP growth

Nominal GDP growth is expected to remain well below trend in 2015-16, reflecting the weak outlook for wages and domestic prices and the falling terms of trade. Nominal GDP is forecast to grow by 4¼ per cent in 2015-16 (Chart 9).

Chart 9: Nominal GDP growth

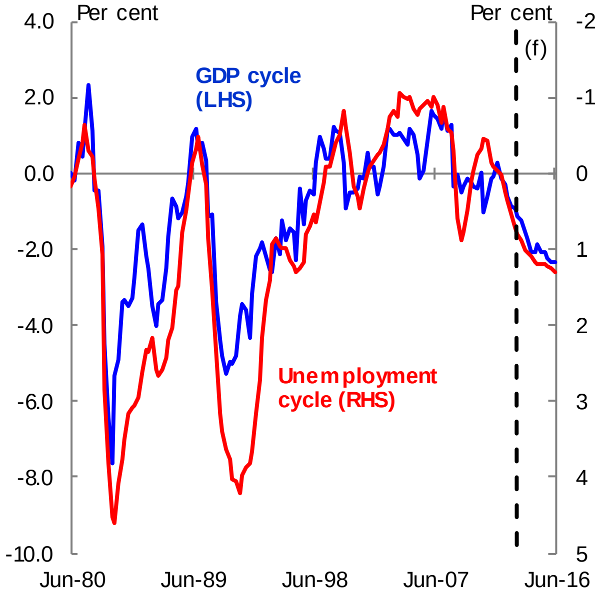


Source: ABS cat. no. 5206.0 and Treasury.

A significant output gap is likely to exist by the end of the forecast period

On current forecasts there is expected to be an output gap at the end of 2015-16 of around 2½ per cent of GDP (Chart 10). A gap of this size has not been experienced since the 1990s recession and reflects below trend growth for six of the eight years (including forecasts) following the global financial crisis.

Chart 10: Estimates of output gaps



Source: ABS cat. no. 5206.0 and Treasury.

Since MYEFO, a revised methodology has been adopted to close the output gap. The gap is closed using a constant year-average growth rate over a five year period after the detailed forecast years, 2013-14 to 2015-16. This ensures that labour market variables converge from their cyclical values at the end of the forecast period to their long run trends, or levels.

Under this framework, wages respond to the gap between the unemployment rate and the Non-Accelerating Inflation Rate of Unemployment (NAIRU), which is currently estimated to be around 5 per cent. Projected wages growth is weaker than at MYEFO, with an extended period of below-trend wages growth helping to unemployment transition gradually back to the NAIRU. With output price growth largely determined by wage costs, below-trend wages leads to weaker price growth. Compared to MYEFO, weaker price growth is offset by above-trend real GDP growth over the forward estimates but lowers nominal GDP growth in the medium term.

Risks to the outlook appear to be more balanced

As outlined in the MYEFO, there are clear risks to the domestic outlook. The pace of rebalancing remains unclear. High profile job losses and the current weakness in the labour market have the potential to slow the transition further.

However, there are tentative signs that the non-resources sectors are responding to stimulatory monetary policy. If combined with a lower exchange rate and an improvement in household confidence, this could result in a quicker rebound in activity than currently forecast, particularly in 2015-16.

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Table 2: Domestic economy forecasts (a)

	Outcomes (b)	Forecasts		
	2012-13	2013-14	2014-15	2015-16
Panel A - Demand and output(c)				
Household consumption	2.0	2	2 3/4	3 1/4
Private investment				
Dwellings	-0.4	3	5 1/2	4
Total business investment(d)	6.1	-1 1/2	-2	-4
Non-dwelling construction(d)	13.8	-1 1/2	-7	-11 1/2
Machinery and equipment(d)	-4.3	-4 1/2	4 1/2	4 1/2
Private final demand(d)	2.8	1 1/4	1 3/4	1 3/4
Public final demand(d)	-1.3	1	1	1 1/4
Total final demand	1.9	1 1/4	1 1/2	1 1/2
Change in inventories(e)	-0.3	0	0	0
Gross national expenditure	1.6	1 1/4	1 1/2	1 3/4
Exports of goods and services	6.0	5	6 1/2	7
Imports of goods and services	0.3	-1	2	1 1/2
Net exports(e)	1.2	1 1/4	1	1 1/4
Real gross domestic product	2.7	2 1/2	2 1/2	3
Non-farm product	2.8	2 1/2	2 1/2	3
Farm product	-3.9	3	1	1
Nominal gross domestic product	2.5	3 1/2	3 1/2	4 1/4
Panel B - Other selected economic measures				
External accounts				
Terms of trade	-9.8	-5	-5	-3
Current account balance				
$billion	-54.9	-58	-66 1/4	-66 1/4
Percentage of GDP	-3.6	-3 3/4	-4	-4
Labour market				
Employment (labour force survey basis)(f)	1.2	1/2	1 1/2	1 1/2
Unemployment rate (per cent)(g)	5.6	6	6 1/4	6 1/4
Participation rate (per cent)(g)	65.1	64 3/4	64 3/4	64 3/4
Prices and wages				
Consumer Price Index(h)				
- headline	2.4	3	2	2 1/2
- underlying	2.5	2 3/4	2 1/4	2 1/2
Gross non-farm product deflator	-0.3	1	3/4	1 1/2
Wage Price Index(f)	2.9	2 3/4	2 3/4	3

(a) Percentage change on preceding year unless otherwise indicated.
(b) Calculated using original data unless otherwise indicated.
(c) Chain volume measures except for nominal gross domestic product which is in current prices.
(d) Excluding second-hand asset sales from the public sector to the private sector.
(e) Percentage point contribution to growth in GDP.
(f) Seasonally adjusted, through-the-year growth rate to the June quarter.
(g) Seasonally adjusted rate for the June quarter.
(h) Through-the-year growth rate to the June quarter.

Note: The forecasts for the domestic economy are based on several technical assumptions. The exchange rate is assumed to remain around its recent average level — a trade-weighted index of around 70 and a $US exchange rate of around 91 US cents. Interest rates are assumed to move broadly in line with market expectations. World oil prices (Malaysian Tapis) are assumed to remain around US$118 per barrel.

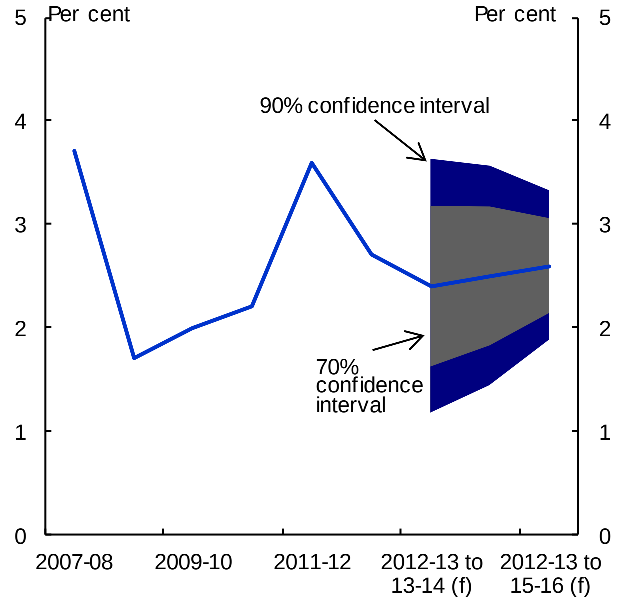
Source: ABS cat. no. 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.

Appendix A – Confidence intervals

As always, there is a degree of uncertainty around the forecasts. The degree of uncertainty can be estimated based on past forecast errors and presented using confidence intervals. The average annualised real GDP growth over the three years 2012-13 to 2015-16 is expected to be 2.6 per cent, with the 70 per cent confidence interval from 2.1 to 3.1 per cent (Chart 1).

It is noticeable that the confidence intervals shrink in width for the 2015-16 year forecast. This occurs because reporting the average annualised growth rate moderates the impact of errors over longer horizons. By contrast, if confidence intervals were reported around the cumulative growth rates they would continue to widen.

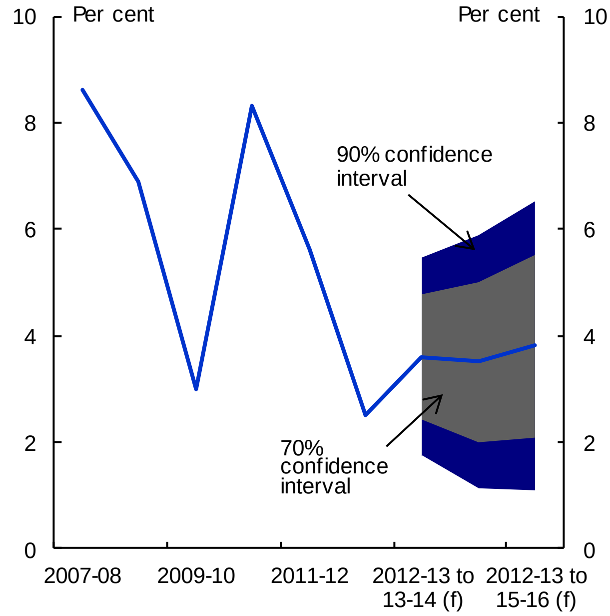
Chart 1: Confidence intervals around forecast real GDP growth



Note: Confidence intervals are based on forecast errors from historical December forecast rounds. The confidence intervals around the 2015-16 forecast reflects errors typically based on projections.
Source: ABS cat. no. 5206.0, Budget papers and Treasury.

The uncertainty around nominal GDP growth forecasts is larger than around real GDP growth forecasts, reflecting the compounding nature of two sources of uncertainty: the outlook for real GDP and the outlook for prices or the GDP deflator. The average annualised nominal GDP growth over the three years 2012-13 to 2015-16 is expected to be 3.8 per cent, with the 70 per cent confidence interval over the three years from 2.1 to 5.5 per cent (Chart 2).

Chart 2: Confidence intervals around forecast nominal GDP growth



Note: Confidence intervals are based on forecast errors from historical December forecast rounds. The confidence intervals around the 2015-16 forecast reflects errors typically based on projections.
Source: ABS cat. no. 5206.0, Budget papers and Treasury.

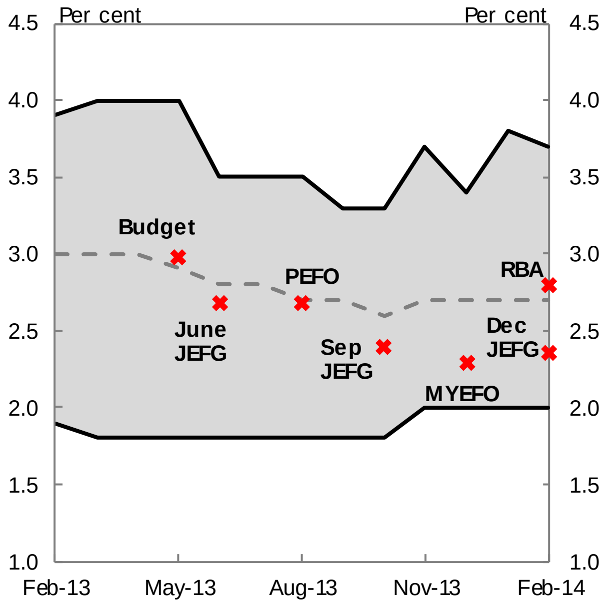
The confidence intervals in the December JEFG are derived from forecast errors based on December round forecasts from 1998 onwards, with outcomes based on the September quarter 2013 National Accounts data. Forecast errors are calculated using the root mean square error of percentage growth rates.

In the charts, the central line shows the year average growth rate outcomes and December JEFG forecasts of annualised average growth rates from 2012-13, reported from 2013-14 onwards.

Appendix B – Forecast comparison

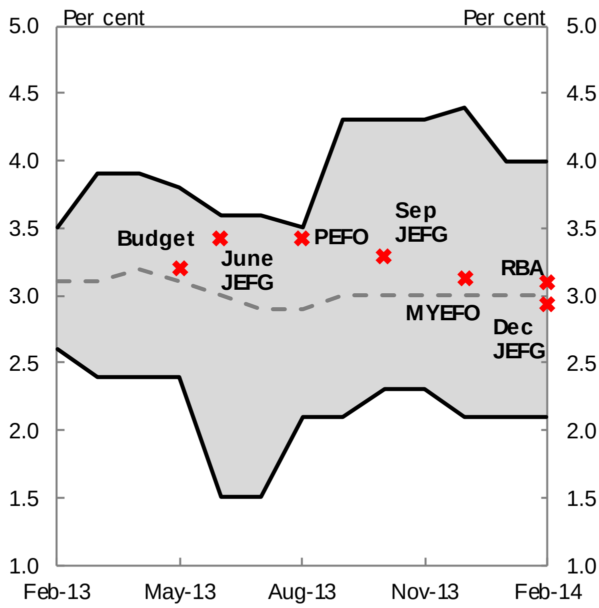
Real GDP forecasts are broadly in line with private sector forecasts but below the RBA…

Chart 1: Real GDP forecasts for calendar year 2014



Note: Top and bottom line represent the range of Bloomberg forecasts. Centre line represents Bloomberg mean forecast.
Source: Bloomberg[3], RBA and Treasury.

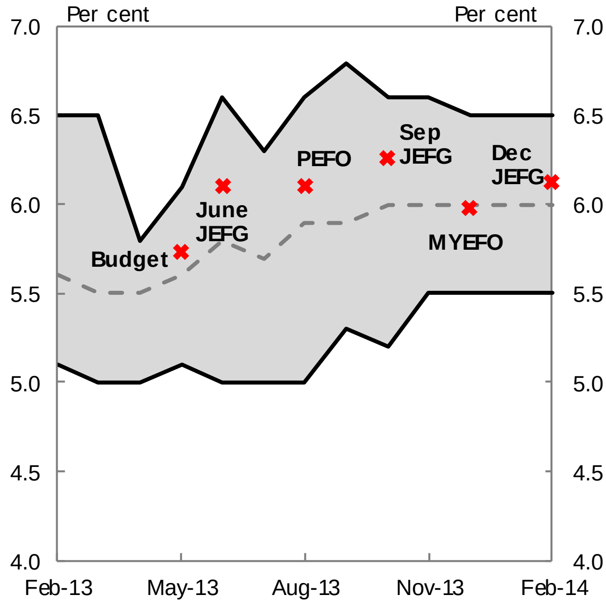
Chart 2: Real GDP forecasts for calendar year 2015



Note: Top and bottom line represent the range of Bloomberg forecasts. Centre line represents Bloomberg mean forecast.
Source: Bloomberg, RBA and Treasury.

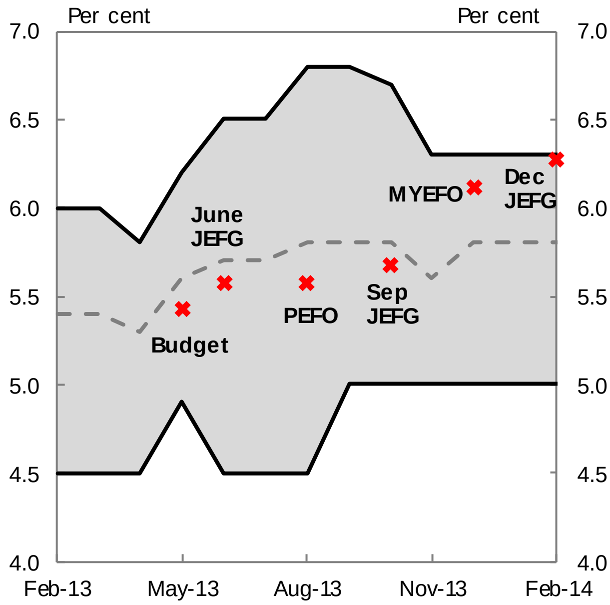
…although the forecast unemployment rate is a little above the mean…

Chart 3: Unemployment rate forecasts for calendar year 2014



Note: Top and bottom line represent the range of Bloomberg forecasts. Centre line represents Bloomberg mean forecast.
Source: Bloomberg and Treasury.

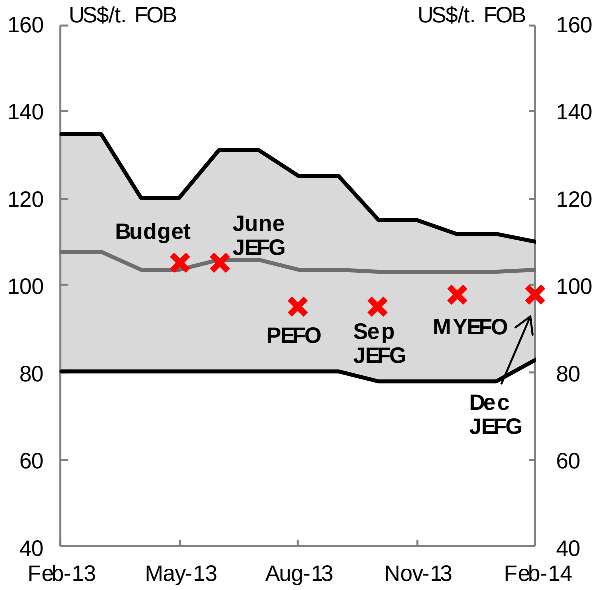
Chart 4: Unemployment rate forecasts for calendar year 2015



Note: Top and bottom line represent the range of Bloomberg forecasts. Centre line represents Bloomberg mean forecast.
Source: Bloomberg and Treasury.

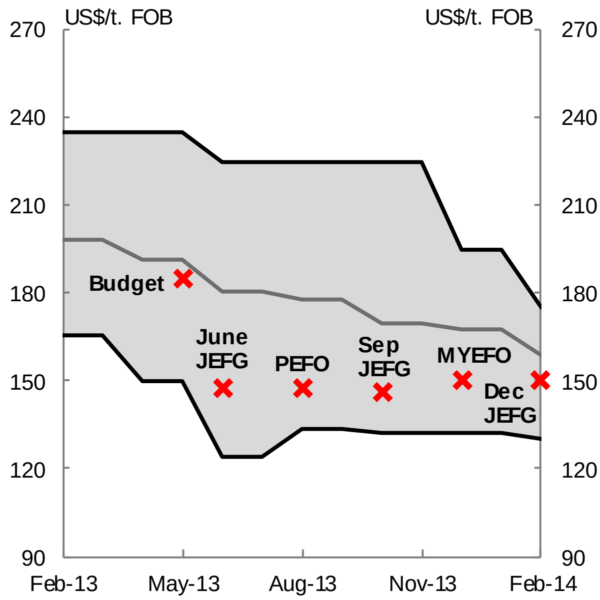
...while bulk commodity price forecasts are at the lower end of consensus.

Chart 5: Iron ore price forecasts for June 2015



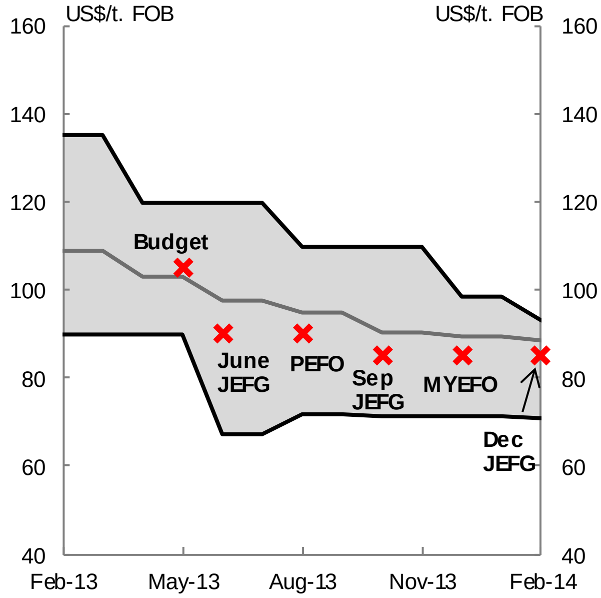
Note: Top and bottom line represent range of consensus forecasts.
Centre line represents Consensus median forecast.
Source: Consensus Economics[4] and Treasury.

Chart 6: Metallurgical coal price forecasts for June 2015



Note: Top and bottom line represent range of Consensus forecasts.
Centre line represents Consensus median forecast.
Source: Consensus Economics and Treasury.

Chart 7: Thermal coal price forecasts for June 2015



Note: Top and bottom line represent range of consensus forecasts.
Centre line represents Consensus median forecast.
Source: Consensus Economics and Treasury.

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[3] *Bloomberg regularly surveys a range of prominent Australian financial and economic forecasters for their estimates of a range of variables, including future growth, the labour market, inflation and exchange rates.*

[4] *Consensus Economics surveys commodity price forecasters every two months.*